"ECONOMIC POLICY AND INTERNATIONAL BUSINESS"

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I would like to thank you for the opportunity to discuss developments in international markets and their relation to monetary policy. The sharp increase in the value of the dollar from 1980 to 1984 and the ballooning current account deficit have been issues of serious concern for participants in international exchange and for policymakers for some time. This concern has sparked calls for trade policy and monetary policy responses that, I think, are wholly inappropriate. Moreover, the sources of recent developments are not well understood. I would like to offer an alternative perspective on the source of the dollar appreciation and address what I regard to be the mistaken policy conclusions that many observers have drawn from the recent experience.

Why Did the Dollar Rise?

There are various explanations of how exchange rates are determined. All of them, however, can be captured by the concepts of the supply of dollars and demand for dollars in international exchange. A currency rises in value either because the demand for the use of that currency in international exchange rises or because the supply of it falls. Popular discussions of the trade deficit and the increase in the value of the dollar suggest that an unrestrained rush to debt-financing of private and government consumption in the United States raised interest rates. On this view, the rise in the value of the dollar has been due to the foreign demand for dollars to lend to U.S. residents, on what are, for us, very unfavorable terms.

The domestic counterpart of our consumption binge, of course, is the expectation that such high real rates of interest "crowd out" productive domestic investment in plant, equipment and housing by rendering such projects unprofitable.

The implication of this view is that we are mortgaging our future. The United States as a growing debtor in international markets is consuming its wealth, reducing its capacity to produce in future years and, at the same time, promising to transfer unusually large amounts of future goods and services to the rest of the world to service or repay our indebtedness.

There is another view of recent international developments. A rise in the external value of the dollar can also be caused by a reduced supply of dollars in international exchange. Such a reduction can arise from a decline in desired U.S. investment abroad.

The 1981 tax act changed U.S. investment incentives. The adoption of liberalized depreciation accounting, expensing of small capital expenditures, the extension of the investment tax credit and reduced corporate income tax rates lowered business taxes and substantially raised after-tax real rates of return on domestic business investment.

An increase in the after-tax real rate of return on domestic business investment not only increases such investment, it increases demand for credit and interest rates. The financing of the domestic expansion has been accomplished, in part, by reduced investment in foreign plant and equipment and reduced lending to the rest of the world.

This trend has been reinforced, of course, by foreign developments. Not only does investment outside the United States have to compete with more attractive returns in the United States, but seriously adverse cyclical and secular trends in most of the rest of the world have reinforced incentives to invest more in the United States. Foreigners, along with U.S. residents, have faced reduced opportunities to invest outside the United States. These changes suggest both a rise in the demand for dollars and a fall in the supply of dollars in international markets.

But the major thrust, in this alternative view, has been a reduction in the supply of dollars in international exchange markets. The demand for dollars in international exchange which was formerly met, in part, by our exports of dollars to acquire foreign real and financial assets has been met only at a sharply higher price of the dollar.

The broad generalizations arising from the "consumption binge" view are fundamentally different in the "investment binge" view. The mounting indebtedness to the rest of the world has not occurred because we are expanding our liabilities faster than our assets. Instead, our liabilities are growing because of a strong demand for asset accumulation in the United States. Instead of every dollar borrowed abroad decreasing our wealth, we are borrowing largely because expected rates of return exceed what may even be an unusually high cost of funds. Thus, national wealth is being expanded, not consumed.

What Evidence is There for These Competing Views?

The view that the U.S. economy is on a consumption binge manifested in an unusual demand for dollars by foreigners has at least two tangible implications that are sharply at odds with the alternative view. First, private saving and investment in the United States should fall reflecting our increased consumption. Second, the demand for dollars by foreigners, especially to lend to us, should have grown much faster than our income, reflecting our borrowing from foreigners to finance our excessive consumption. The investment binge view, implies the opposite; domestic business investment and private saving should have risen, and the flow of dollars supplied to the foreign exchange market should have declined relative to our income.

The performance of the U.S. economy is more supportive of the investment binge view, when the data for the first half of 1985 are compared with 1980, the year when the dollar began to rise. Gross private domestic investment rose from 15.3 percent of GNP in 1980 to 16.8 percent in 1985. Private saving rose from 16.6 percent in 1980 to a post-World War II high of 17.8 percent of GNP in 1985. When we focus on investment in business structures, plant and equipment, the investment performance is more impressive. Real purchases of such goods rose from 11.3 percent of real GNP to 13 percent in 1985. Even at the lowest investment pace over the past five years, following the 1981-82 recession, real business fixed investment was roughly the same share of our real output as during the investment booms of 1966-67 and 1973.

Thus, the crowding-out of domestic investment expected from the overconsumption view has not occurred. Instead, the growth in our net indebtedness to the rest of the world is largely due to the improvement in investment opportunities domestically--opportunities that when exploited add more to our production capacity than the debt servicing cost. Productivity growth in the United States also shows the acceleration in capital accumulation. Business output per hour has risen at a 1.8 percent rate since 1980. This rise is three times as large as that achieved during the previous seven years of negligible growth.

In the international exchange market the evidence is the same. From 1980 to 1985, net foreign investment in the United States--essentially the difference between what foreigners invest here and what we invest abroad--rose from -0.2 percent of GNP in 1980, reflecting a net outflow from the United States, to 3.0 percent of GNP in the first half of 1985. But this source of finance was not due to a significantly increased share of foreign investment in the United States. Instead, net foreign investment rose because the pace of U.S. investment in the rest of the world fell from $86.1 billion in 1980 to only a $6.5 billion annual pace in the first half of 1985. Our supply of dollars in international exchange for acquisition of foreign assets fell sharply, reflecting the switch to the accumulation of real assets in the U.S. economy by domestic residents.

So What's the Problem?

Obviously, I believe that a failure to understand the positive U.S. economic developments that gave rise to the appreciation of the dollar is the major problem, because such a failure could induce inappropriate and adverse policy actions. But equally obvious, there are sectors of the U.S. economy that have been adversely affected by recent changes in our economic environment. Also, there are sectors where the popular view, that wealth is being consumed or eroded, is correct.

For example, federal government expenditures have risen sharply since 1980, and these expenditures have been largely financed by borrowing. These expenditures do not reflect increased purchases of goods and services by governmental units. Instead, this expenditure growth represents increased transfer payments, including a large rise in the share of interest on the national debt. Such transfer payments raise private disposable income and consumption. Moreover, their financing, through borrowing, crowds out investment and the growth of the nation's capacity to produce.

Similar decisions are being made in the private sector. Not all of the rise in business demand for funds has been used for capacity expansion. In some industries and households, growth in debt has been necessary to service outstanding indebtedness at relatively high interest rates. The agricultural sector is a well-known example. The painful process of scaling back operations or cutting other expenditures to adjust to the relatively high interest rates of the past five years have been postponed or delayed to an extent in these industries. It may be desirable to spread out costly adjustments over time by borrowing rather than cutting back other expenditures, especially if adverse cost increases are viewed as temporary. But the sooner the adjustment is made, the smaller will be the future adjustment or sacrifice that will be necessary.

There is, perhaps, no more popular solution to the difficulties occasioned by unusually high interest rates and the increased value of the dollar than cutting the federal budget deficit. Such deficits are an example, as I have indicated, of easing the burden of temporary adverse economic developments like unemployment and cyclically depressed private income. But one thing is clear. Reducing the deficit through cuts in federal expenditures could provide some essential relief to all borrowers in the United States and abroad and improve the viability of several threatened industries in the United States.

I believe that continuing large federal deficits are also perceived as posing a substantial risk of accelerating inflation. Removing this risk will improve the climate for capacity expansion in the United States and will improve the outlook for the traded goods sector of the U.S. economy and the world.

I also believe that we must be clear on the extent of the problems in the traded goods sector and, in particular, not overstate the problem. First, exporters and import-competing producers have benefited from the tax incentives provided by the 1981 tax act. Indeed, in some areas, lower prices reflect the improvements in our international competitiveness, not increased foreign competition. There are industries in which the expansion in our domestic demand has exceeded the growth in our capacity to produce, so that we are importing more or exporting less. Such strong growth in U.S. capacity and demand can hardly be viewed as a problem, either for domestic industry or consumers. Secondly, the mounting trade deficit is erroneously perceived to have reduced U.S. employment. Employment in the United States has expanded by 7.4 million workers and jobs since 1980, keeping pace with growth in the nation's labor force. A recent study of 76 industries has shown that there has been no correlation between growth in import competition and employment declines since 1980. Industries showing the greatest growth in import competition since 1980 have shown growth in employment that is no slower than average.

Is Trade Policy the Solution?

There is mounting pressure in this country to address recent international developments with protectionist policies such as tariffs or quotas on imports. Such policies attack a symptom of the increased value of the dollar--the trade deficit--and not the cause. Such policies would further restrict the supply of dollars in international exchange. A reduced ability to earn dollars through foreign trade also reduces the ability of the rest of the world to buy our exports. Thus, such policies would invite retaliation, further raise the value of the dollar and further worsen our exports and trade balance.

More importantly, closing our markets to foreign competition would result in a heavy loss in efficiency in the United States, substantially lowering our future standard of living. There is no more disastrous way that I know of to worsen our international competitiveness and the growth of U.S. income and employment than the adoption of such protectionist policies.

Can Monetary Policy Help?

There also have been calls in this country for the use of monetary policy to assist the traded goods sector. But how?

If the nation were consuming its wealth through short-sighted and wasteful debt expansion, then monetary authorities could make this trend more difficult by restraining money and credit growth. Such a policy would create cyclical output and employment losses; it would reduce imports, and improve the current account balance temporarily. But such a policy also shows the dilemma of attempting to conduct monetary policy to influence the performance of the traded goods sector. Slower growth in the supply of money and credit tends within a very short time to lower interest rates because of both the cyclical effects on the demand for credit and because it promotes a reduction in inflationary expectations. But the reduction in U.S. inflation relative to other countries tends to further raise the value of the dollar. In the long run, monetary policy cannot simultaneously lower interest rates and the value of the dollar.

Faster growth of money and credit also does not provide a solution. Such actions inevitably raise inflation and the inflation premium in interest rates. Interest rates would be higher, not lower. Admittedly, the value of the dollar would fall, but this would not improve the outlook for U.S. exporters or import-competing sectors. The falling dollar would simply reflect its deteriorating value, or faster inflation. Faster inflation would damage the competitiveness of U.S. producers by raising the cost of capital to all firms and by reducing after-tax real rates of return to savers. The recent enhancement to capital accumulation would tend to be reversed, and future wage and income improvements would be jeopardized.

I believe the inflationary experience of the latter half of the 1970s is still fresh in people's minds. What we saw then was a declining dollar and rising interest rates. Neither helped our international competitive position as the trade balance deteriorated. Further, U.S. real wage and capital income improvements virtually came to a halt.

Conclusion

I believe the fundamental problem in the current debate over the rising dollar and burgeoning trade deficit is a failure to understand its source. This failure has given rise to demands for trade and monetary policy changes that would permanently worsen the competitive position of the United States in international markets. We can lower the value of the U.S. dollar in international exchange by choosing policies to slow the growth of our productive capacity relative to our trading partners. Either protectionist trade legislation or inflationary monetary policy can bring about such a reduction in our standard of living and our economic growth rate. But such a course is unnecessary and the height of masochism in public policy.

The marketplace will correct the perceived imbalances in international markets. Capacity growth in the United States is contributing to strengthening our competitive position in world goods markets. The surge in credit demand to finance this expansion is largely over. Foreign markets and economies also appear to be moving in positive directions, with employment and output beginning to expand. The growth in foreign income is essential to restoring demand in markets for U.S. exports, especially in agriculture and agricultural related equipment, chemicals and other materials.

Policies abroad can also be helpful. Some of these policies were outlined and agreed to in the recent G-5 accord. Improvements in foreign investment incentives can enhance capacity expansion abroad, furthering growth in world output, employment and real income. Sectoral adjustment loans to less developed countries, contemplated in recent international proposals by the United States, would also help in improving foreign income and employment and the market for U.S. exports.

Finally, where debt expansion to foster unsustainable consumption levels is occurring, especially in U.S. and foreign government transfer programs, budget cuts can ease the difficulties associated with the expansion of productive capacity.

I am encouraged that international policy understanding is moving in line with such a program. More important, I think that international market adjustments since the Spring of this year have begun to lessen the perceived imbalances in international exchange. The dollar appears to have peaked in the Spring of this year and has declined more than 20 percent since then. The trade deficit appears to be near its peak or declining. The inordinate strength of U.S. business fixed investment appears to be moderating. Fortunately, these developments appear to be occurring without a reversal of U.S. growth incentives and without renewed inflationary pressures in the U.S. and world economy. But, these adjustments also are not costless. They suggest that output and employment growth are likely to slow and that the risks of higher inflation and interest rates are growing. But the most important step now is to stem the rush to monetary or trade policy changes that would be counterproductive to U.S. and world trade. I trust that this conference will be of assistance in contributing to the defusing of these initiatives.